For Professional Investors

UK REAL ESTATE

Signs of impending doom or opportunity? – Multi Asset Solutions - 07/07/2016

- **We pencil in a short and fairly mild post-Brexit recession**
- **Real estate – weakening cyclical dynamics exacerbated by Brexit**
- **What's in the price of listed real estate now?**

The UK economy did well in recent years. While the eurozone economy only managed to fully recoup the losses from two recessions since 2008/09 in the first quarter of this year, the UK economy had surpassed the pre-crisis peak already in the third quarter of 2013. In the first quarter of this year, the UK economy was 7.0% larger than at the peak in early 2008, putting it well ahead of Germany and France. Wages have grown modestly, but the housing market has strengthened enough to trigger measures to prevent overheating.

Even before the vote in favour of leaving the EU, cracks had started to appear. Fixed investment fell in the fourth quarter of last year and the first quarter of this year and consumer confidence and retail sales growth slipped. Leading indicators pointed to a growth slowdown.

We expect the uncertainty after the referendum result to push the economy into recession by the end of the year. Political uncertainty and ambiguity about the ties with the EU, the UK's main trading and investment partner, should severely dent business investment. Household consumption may suffer in three ways: through souring sentiment, higher unemployment and a weakening housing market. How deep this recession will be depends on the outcome of the negotiations with the EU.

For now, we have pencilled in a short and fairly mild recession. In our view, this will trigger monetary easing in the form of base rate cuts and possibly a restart of government bond purchases by the Bank of England. Its room for manoeuvre looks somewhat limited. The sharp drop of the pound, in itself positive for exports and corporate profits, should lead to higher inflation and lower purchasing power for consumers.

Source: Bloomberg, BNPP IP, July 2016

UK REAL ESTATE – WEAKENING CYCLICAL DYNAMICS EXACERBATED BY BREXIT

Excluding the Brexit impact, the cyclical supply-demand dynamics for UK commercial real estate, which have been strong for the past three years, were starting to weaken anyway: supply increased in the London office sector this year (see chart below for a pre-Brexit report of expected supply).

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While the uncertainty over Brexit should choke off some of the future speculative development, the supply under construction will still come to market. With little prospect for large-scale job growth, it is likely that property vacancy levels will rise, putting pressure on the commercial property market.

REAL ESTATE IN A MULTI-ASSET CONTEXT

In a multi-asset framework, commercial real estate exposure is typically a capital-intensive real asset. The greater stability of its cash flows compared to equities is what makes it an enticing portfolio diversifier for investors. The critical component here is stability (i.e., comparatively lower risk).

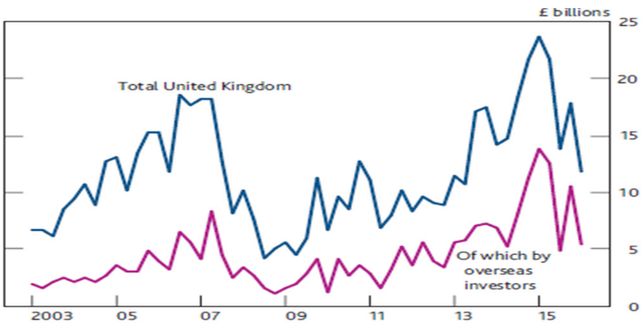
For some time now, real estate investments in (or around) the main gateway cities of the world have been seen as bastions of stability and strength amid slower global growth. The perceived stability and lower risk led to several years in which foreign investors invested significantly in key developed market real estate – the UK having been a notable beneficiary.

UK REAL ESTATE STABILITY BEING QUESTIONED

The stability has been called into question throughout 2016 and since 23 June acutely so, benefiting more resilient markets such as the US, eurozone and Australia.

The rise in uncertainty hit commercial real estate transactions in the first half, ahead of the referendum (see chart below1).

UK CRE transactions (gross quarterly flows)



Source: The Property Archive, BoE, BNPP IP

While large open-ended direct real estate funds had raised large amounts of cash in the run-up to the vote, redemption pressures since the referendum result proved too high and many large non-listed real estate funds have now had to temporarily close their funds to protect their remaining clients.

The spike in uncertainty over the post-Brexit outlook for the UK economy (relative to other OECD economies) has exacerbated the increase in redemptions already underway amid signs that the property cycle was peaking.

This episode serves as a reminder of the concerns raised previously by the Bank of England over the mismatch of the (limited) liquidity of funds invested in illiquid assets and the promise of daily liquidity they make to investors.

Given that over the long term, the return streams of listed and non-listed real estate are highly correlated, the Multi Asset Solutions team invests in real estate through listed real estate companies rather than in direct non-listed real estate.

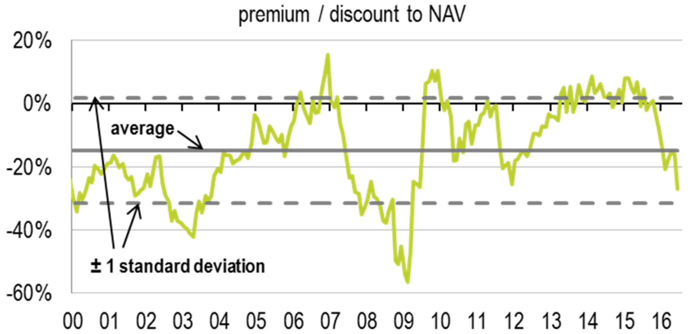
With the property market under pressure from concerns over its stability and the heightened post-referendum uncertainty, the listed real estate segment has suffered too. This has turned Throughout 2016 UK listed real estate has underperformed a lot. Year to date (and over the past 2 weeks), listed real estate has outperformed equities in most other major developed countries/regions around the world (US, Eurozone, Japan & Australia). UK real estate is the clear exception.

UK LISTED REAL ESTATE – WHAT'S IN THE PRICE?

Given the persistent uncertainty on the political front, we expect the economy to suffer and commercial real estate prices to fall. The questions are: how long for, by how much and is the worst-case scenario already priced in?

After this year's considerable price falls, listed real estate is now priced for a roughly 25% drop in underlying property values (see chart below).

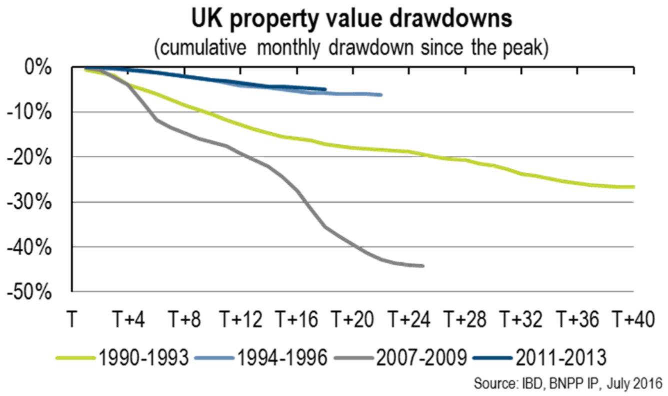
UK Real Estate
premium / discount to NAV



Source: UBS, BNPP IP, July 2016

To put the slump priced into the market into context, the worst property cycle busts in the past 25 years (1990-1993 & 2007-2009) saw values drop by 25% and 40% respectively (see chart below) and it took two to three years for values to bottom.

[1] Bank of England Financial Stability Report, July 2016



Our expectation is that a 'bad outcome' for UK commercial property would most likely resemble the 1990-1993 slump.

Two key differences between the situation in the UK in 1990 and 2007 compared to today are:

- UK banking system exposure to commercial real estate. In 1985-1990 and 2000-2007, commercial real estate lending by banks rose significantly, leaving banks heavily exposed and causing the fall in property prices to exacerbating those recessions. Since 2007, banks have dramatically cut their exposure and notably improved their capital buffers too.

In light of the sector's improved position, the BoE was able to respond to the Brexit fallout by lowering the requirements for banks' counter-cyclical buffers, freeing up liquidity to handle any fallout risks. The risk that the fallout in the commercial real estate spreads to the banking sector is likely to be more limited this time and banks are unlikely to withdraw funding to the same degree as they did in prior commercial real estate downturns.

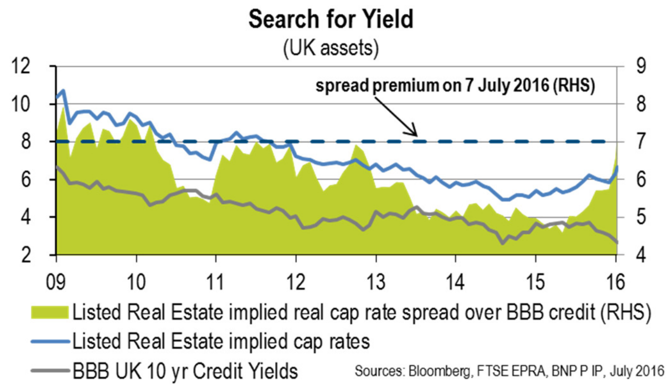
So far, UK corporate credit spreads have not blown out despite the financial shocks of recent weeks. We expect the BoE to be better able to contain this during a recession.

- The amount of gearing by property companies. In previous cycles, many real estate companies ramped up leverage considerably to increase returns, forcing them to raise significant equity capital to remain solvent in a downturn. This is not the case today.

UK listed real estate companies have successfully deleveraged their balance sheets since the 2008 crisis so that solvency and dilution risks are lower now and these companies will be in a position to buy assets at discounts if there are distressed sellers on the other side.

IS THERE AN OPPORTUNITY NOW?

If credit spreads remain resilient, the BoE implements significant easing and the government supports the economy with fiscal measures, the current uncertainty should wane, encouraging investors to reconsider UK real estate as an asset class with an attractive yield. However, this could take time. The premium of UK real estate risk over UK corporate credit has risen substantially to levels seen in 2009 and 2010.



As such, while we expect commercial real estate prices to fall during this period of uncertainty, we believe a steep drop in values is now largely priced in. We do not yet see sufficient evidence as to why this market slump should resemble the one seen in 2008. Likewise, we do not see such a fall in values causing significant contagion issues for UK banks either.

CONCLUSIONS FOR OUR ASSET ALLOCATION

We think the UK economy is headed for a recession and a period of prolonged uncertainty. While we have been cautious on UK real estate throughout 2016, we expect to see more volatility as the uncertainty continues to weigh on the asset class.

The market is pricing in a 'bad outcome' and giving little weight to a positive turn materialising in the years ahead. However, we believe that it is still too soon to buy listed UK real estate and that a better opportunity is likely to arise to do so.

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